

Office of Chief Counsel  
Internal Revenue Service  
**memorandum**

CC:WR:LA:TL-N-2824-99

date: February 3, 2000

to: Tere Itokazu  
Financial Products Specialist, FP1227  
IRS, Los Angeles

from: Marilyn Devin, Attorney  
District Counsel, Los Angeles

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subject: [REDACTED] - Debt-Equity Issue

You have requested an informal opinion from District Counsel in this case as to a potential debt-equity issue arising from the Taxpayer's issuance of certain Senior Debentures. For the reasons discussed herein, we do not believe this adjustment should be pursued.

**Facts**

[REDACTED] formerly known as [REDACTED] was first organized in [REDACTED] as a California corporation; the current entity is a successor formed in [REDACTED] under the laws of Delaware. It is a diversified international [REDACTED] company, with [REDACTED] accounting for somewhat less than half its revenues, [REDACTED] activities accounting for an equal amount, and [REDACTED] products generating the remaining [REDACTED] percent of annual revenues.

The early [REDACTED] were a period of [REDACTED] for the Taxpayer, which consequently sought an infusion of new funds. Following the creation of an Indenture with [REDACTED] in [REDACTED] the Taxpayer issued a substantial series of debt securities, the proceeds of which were to be used "for general corporate purposes." The offerings consisted of up to [REDACTED] dollars of "Medium-Term Notes" in [REDACTED] including \$[REDACTED] in "Senior Debentures" in [REDACTED]. Your question deals with these Senior Debentures.

According to the "Pricing Supplement" to the [REDACTED] Prospectus and Supplement, these [REDACTED] percent debentures were to be [REDACTED] year notes, with a maturity date of [REDACTED]. You see these debt instruments as the source of a possible tax issue in view of their unusually long term. In your view, the remoteness of the maturity date diminishes the investors' right to be

repaid to such an extent that the instruments may have more in common with equity than with debt.

Should these "██████ Bonds" be recharacterized as equity, of course, the Taxpayer would not be entitled to deduct the amounts it has paid (and will pay) as interest thereon.

### Discussion

Periodic payments made with respect to a debt obligation are deductible as interest under Internal Revenue Code Section 163, but only if the obligation is a valid indebtedness of the payor. "The classic debt is an unqualified obligation to pay a sum certain at a reasonably close maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof. While some variation in this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, ... too great a variation will ... preclude such treatment." Gilbert v. Commissioner, 248 F.2d 399, 402-03 (2d Cir. 1957).

Whether an instrument represents indebtedness or an equity investment for federal income tax purposes depends on the facts and circumstances of each case. No particular fact, standing alone, is conclusive. John Kelley Co. v. Commissioner, 362 U.S. 521 (1946). As outlined in your request to our office, there is an array of factors to consider in any debt vs. equity analysis. The ones you delineate are:

- whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- whether holders of the instrument have the right to enforce payment of principal and interest;
- whether the holder's rights are subordinate to those of general creditors;
- whether holders have the right to participate in the management of the issuer;
- whether the issuer is thinly capitalized;
- whether the holders of the instrument are, in fact, the shareholders of the issuer;
- how the instrument is labeled by the parties; and
- whether the instrument is consistently treated as debt for other, non-tax purposes.

Your primary concern is the first of the above factors.<sup>1</sup> You logically note that a maturity date █████ years in the future is hardly "foreseeable." But the operative test

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<sup>1</sup> Your request does also point out two other features of the bonds: (1) there are limits on the debenture holders' rights to enforce payment, in that not less than █████ percent of them would have to act in concert in the event of default; and (2) the debentures, being unsecured, rank equally with all other senior unsecured indebtedness of the Taxpayer; you refer to their subordination to the rights of other creditors with respect to assets of the Taxpayer's subsidi-

is reasonableness, rather than foreseeability, and reasonableness can only be addressed in context. You have not given any facts about the Taxpayer's capital structure or credit rating, but it is in general known as a healthy, stable, global corporation, and we are probably safe in assuming and that there was no question of excessive debt or "thin capitalization," or of an unsatisfactory credit rating when these debentures were issued. Proceeding on these assumptions, was there anything unreasonable about the debentures' ■■■-year term?

In Ruspyn Corp., 18 T.C. 769 (1952), an 89-year term was found to be acceptable where the period was substantially coextensive with the term of a ground lease on the corporation's real property. In Monon Railroad v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, the Court found a debt with a term of 50 years to be reasonable, since "the substantial nature of the [taxpayer's] business, and the fact that it had been in corporate existence since 1897, or 61 years prior to the issuance of the debentures" were all taken into consideration by the Court.

In Swoby Corporation, 9 T. C. 887 (1947), on the other hand, the Court found a purported debt obligation of 99 years to be more akin to equity. But that was because the context *did* make 99 years unreasonable: the 99-year obligation had been issued by a corporation whose principal asset had an anticipated life at the time of acquisition of less than a third of that span. How could the "lenders" anticipate being repaid? Even 15- and 20-year terms have been held excessive, where circumstances so dictated. See, e.g., United States v. Snyder Bros. Co., 367

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aries in the event of the subsidiaries' liquidation or reorganization.

Regarding the enforcement rights, you are correct that the "right to force payment of the sum as a debt in the event of default" is a very significant factor in a debt vs. equity analysis. United States v. South Georgia Ry., 107 F.2d 3, 5<sup>th</sup> Cir. 1939). However, there is considerable authority that requiring the concurrence of a certain percentage of creditors in order to accelerate maturity upon default is *not* inconsistent with indebtedness, since even creditors have an interest in preventing a minority from "upsetting the financial appletart if there should be a default of no genuine economic consequence." Luden's, Inc. v. United States, 196 F. Supp. 526, 533 (E. D. Pa. 1961); Curry v. Commissioner, 43 T.C. 667, 686 (1965).

Regarding the subordination question, you may be placing too much weight on the provision you have quoted from the Prospectus. True, "subordination necessarily destroys one of the essential rights of the creditor, and the willingness to subordinate is indicative of equity investment." Sarkes Tarzian, Inc. v. United States, 240 F. 2d 467, 470-71 (7<sup>th</sup> Cir. 1957). However, the Prospectus merely states that these debenture holders' rights to the assets of the Taxpayer's subsidiaries in the event of the subsidiaries' liquidation will be no greater than the Taxpayer's rights (except as a creditor) in that situation. This provision does not subordinate the rights of the debenture holders to any of the Taxpayer's general creditors' rights.

Neither of these provisions is atypical in comparable public debt offerings, and we do not think that in this case they can be said to militate more than a negligible amount in favor of a finding of equity.

F.2d 980, 984 (5<sup>th</sup> Cir. 1966), *cert. denied*, 368 U.S. 956 (1967); Reef Corp. 24 T.C.M. 379, 397 (1965), *aff'd*. 368 F.2d 125 (5<sup>th</sup> Cir. 1966).

Obviously, even multi-national companies split up, merge, disappear, or change their shape and name, and it is unlikely that any given corporation will be around for ■ years in its present form. But that is different from saying that something exists now which will *prevent* the Taxpayer from fulfilling its obligations to these investors, or that something exists now that should warn these investors that the debt will not be repaid. In short, we would have to point to something about the long term of these debentures that makes it more likely that those who purchased them did so with the intent of putting their money at the risk of the Taxpayer's business, rather than simply lending it with the expectation of repayment.

Paradoxically, although this question is the crux of the issue, it is disingenuous to insist that purchasers of these debentures were thinking about repayment. As noted by many of today's financial market observers, "in the case of even conventional long-term debt with a term of 30 years, the bulk of the present value of the security is not in the right to receive principal back at maturity but in the right to receive periodic interest payments."<sup>2</sup> When viewed from this perspective, the length of the term of an instrument is only a minor factor in the debt equity analysis.<sup>3</sup>

Thus, whether we seriously address the question of the investors' expectation of repayment, or whether we recognize the reality that the debentures probably represented no more than a secure income stream to them, the answer to the debt-equity query is the same: the purchasers did not believe they were putting their funds at the risk of the Taxpayer's business.

The analysis in your inquiry relied heavily on Notice 94-47, 1994-1 C.B. 357, which was published when the Service became aware of a growing number of corporate taxpayers' increasingly aggressive financing schemes. The Notice announced that such schemes would henceforth be more carefully scrutinized, and laid out several factors that would receive close attention. One of the Service's articulated concerns was the trend toward issuing purported debt that had a variety of equity features, including those issues with exceptionally long maturity periods.<sup>4</sup>

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2 HARITON & GARLOCK, "Federal Income Taxation of Debt Instruments" (3d ed.), cited in Sheppard, "News Analysis: Toward Straightforward Section 385 Guidance," 94 TNT 218-4, Nov. 7, 1994.

3 "[A]ny security is really just a stream of payments." Sheppard, *supra*. "Extending the maturity of a conventional debt instrument (even to infinity) does not give it any fundamental attribute of equity." Myers, Treasury Tax Correspondence, 97 TNT 74-27, April 2, 1997.

4 From 1995 through 1997, dollar-denominated century bonds were issued by no fewer than 53 corporations, for a principal amount of \$12.5 billion. The Financier, Vol. 4, Issue 4, November 1997.

The Notice's discussion of long-term debt, however, contained nothing new or different. The Service merely cautioned taxpayers that they should be wary of relying on cases such as Monon Railroad, *supra*, for purposes of treating otherwise doubtful instruments as debt, rather than equity. It never came close to saying that a long term, even an exceptionally long term, would alone tip the balance in favor of equity treatment, nor would that factor weigh any more heavily than it had in the past. Basically, the Notice merely reiterated that "[t]he reasonableness of an instrument's term ... is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present."

Thus the traditional debt-equity analysis is still controlling, and in the absence of any significant facts weighing against debt and in favor of equity, we do not see how we could support your proposed disallowance of interest with respect to these debentures.<sup>5</sup>

#### **Conclusion**

If counsel can be of further assistance, please feel free to call. My number is 213/894-7101.

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